EUROPEAN CONFEDERATION OF INSTITUTES OF INTERNAL AUDITING

POSITION PAPER ON INTERNAL AUDITING IN EUROPE

April 17, 1996

FOREWORD

During the last few years there has been increased international focus on the accountability of management in the public and private sector, inter alia following a number of corporation failures, examples of mismanagement, fraud, etc. The subject of corporate governance has been high on the list of priorities, both as regards governmental bodies and in professional fields, including auditing. Prominent examples of work carried out in this area, are the Cadbury report (UK), COSO report (USA) and CoCo report (Canada).

When the European Commission decided to introduce legislation on statutory auditing, they considered it important to view such legislation in the wider context of corporate governance. Experience has shown that traditional auditing, whose main purpose is a confirmation of specific financial information, is not sufficient to satisfy the needs of a variety of stakeholders in a continually changing and complex business environment.

The European Confederation of Institutes of Internal Auditing therefore took the initiative to present to the Commission a position paper on internal auditing in Europe. Internal auditing is a profession experiencing rapid development and growth in a great many countries and is increasingly being identified as a key factor in corporate governance.

This paper expands on the important role of internal auditors in the private and public sector, describes the concept, purpose and scope of internal auditing as a mechanism for improving senior management's control of the enterprise and explains its value in the wider context of sound corporate governance in Europe.

On behalf of all member organisations of the European Confederation of Institutes of Internal Auditing, I would like to thank Paul Bellamy and the entire task force for the tremendous efforts they have made to develop this position paper. This research work is an important milestone in the future development of internal auditing within Europe.

April 17, 1996

Jean-Pierre Garitte
President ECIIA

EUROPEAN CONFEDERATION OF INSTITUTES OF INTERNAL AUDITING

Position Paper on Internal Auditing in Europe

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Task Force:

Paul Bellamy (Chairman)	Coopers & Lybrand, Norway
Marco Proietti	Alitalia, Italy
André Van Hoek	Janssen Pharmaceutica, Belgium
András Kovács	Inter-Európa Bank Rt, Hungary
Søren Kongsbo	General Directorate of Posts and Telegraph, Denmark
Joe Morris	Institute of Internal Auditors, United Kingdom
Georges Selim	City University Business School, United Kingdom
Romain De Jaeger	Fortis AMEV NV, The Netherlands
Roland De Meulder	Alcatel CIT, France
Tage Rasmussen	The Aarhus School of Business, Denmark
Sten Bjelke	Swedish State Railways, Sweden

Reference group:

Eduardo Hevia Vazquez	Instituto de Auditores Internos, Spain
Jean-Pierre Garitte	J. Van Breda & Co, Belgium
Urs Morgenthaler	Credit Suisse, Switzerland
Trygve Sørlie	Norsk Hydro, Norway
Frederic Charles	Renault, France
T. Flemming Ruud	Norwegian School of Management, Norway
Giovanni Grossi	IBM Italy, Italy
Anikó Felde	Inter-Európa Bank Rt, Hungary
Winfried Hohloch	Institüt für Interne Revision, Germany
Asko Ihalainen	KESKO OY, Finland
Manuel Ventura	Audigrup, Spain
Costas Korolis	Shell, Greece
Norbert Plhak	Österreichische Donaukraftwerke, Austria
Eliezer Weltman	Institute of Internal Auditors, Israel

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0. *EXECUTIVE SUMMARY*

0.1 Corporate governance

In the last decade, and more especially during the last 5 - 6 years, enterprises both in the private and public sector have experienced many new challenges and demands. The combination of a harsh economic climate and rapid developments in technology, market conditions, internationalisation and cost-awareness, have demonstrated the need for new solutions. All sectors experience increased expectations as regards the achievement of defined objectives, efficient use of resources, improved quality in products and services and, in addition, other factors such as environmental awareness.

As such, directors and senior management must seek new ways of tackling their accountability to various interested parties, such as owners, employees, creditors, regulatory authorities and the public-at-large. Experience has shown that many enterprises are not sufficiently equipped to meet this challenge and to fulfil the expectations from stakeholders. The increasing numbers of corporate collapses, crises, scandals and examples of fraudulent activity, only serve to increase the awareness of the problem faced by European enterprises.

0.2 Accountability

As indicated above, directors and senior management as well as other stakeholders, are constantly seeking new ways of monitoring the accountability of management. International research in many countries has focused on the wide scope of corporate governance and the implications this has for management accountability.

One of the most frequently discussed methods is to improve and expand the information given to stakeholders outside of the enterprise, on the performance of the enterprise and management's governance. As such, there is general agreement that a Board of Directors (or its equivalent in the public sector) and/or senior management, should issue external reports confirming the quality of the internal accounting control, as well as the accuracy, completeness and fairness of the presentation of the annual financial statements.

As such there are considerable areas of paramount importance to sound corporate governance which are not the subject of external reporting to stakeholders. This includes business risk management, the efficiency, economy, effectiveness of the operations of the organisations, and

the compliance within the organisation, with established policies, procedures and internal regulations.

0.3 Statutory (external) audit

The statutory audit is a valuable mechanism designed to give information and comfort to many stakeholders, primarily owners and regulatory authorities, through the issue of an audit opinion on the annual financial statements. It is clear that the same restrictions of scope which lessen the value of management's external reporting (see above), also apply to the statutory auditor's opinion. Therefore, there exists an equally important expectation gap between the same stakeholders and the statutory auditors of an enterprise, as regards the purpose, scope and value of the work carried out by the auditors and of the reports/opinions issued by them.

It might seem logical to extend the responsibilities of statutory auditors in order to meet this expectation gap. However, such an extension would necessitate a far closer relationship with executive management, promoting uncertainty as to the auditors role and threatening independence. Further, the assessment of business risk management and the operations of the enterprise, require a high degree of subjectivity in an area where precise measurement and the gathering of objective audit evidence is often difficult or impossible. This would lead to prohibitive external audit costs and a further increase in legal exposure, with resulting litigation problems.

International research concludes therefore that it is both impractical, uneconomic and legally inadvisable to require that the statutory audit be used as a mechanism to oversee corporate governance as a whole. The above, combined with important professional considerations such as the statutory auditor's training, qualifications and methodology, necessitate a restriction in the purpose and scope of this function.

0.4 Control Self Assessment

In all European countries, company legislation, judicial practice and corporate/public sector traditions and guidelines, require management to establish and maintain control of the operations. There are many different factors which can cause losses, failures, fraud and other forms of financial crisis - nonetheless, the expression ‘mismanagement’ is often used to cover all such factors.

There can therefore be little doubt that the Board of Directors and senior management have a duty to establish an adequate system of internal control which covers all aspects of the

operations of the enterprise. It is not sufficient solely to establish sound financial and accounting controls, with the primary objective of issuing necessary financial statements.

Management also has a duty to ensure that the business and operational control mechanisms established, are subject to monitoring by all levels of management throughout the organisation, in order to evaluate both the quality of the controls established and the quality of the organisation's execution of such controls on an ongoing basis. Such a system of monitoring must be established within line management, assisted if necessary by staff functions, and is often termed control self assessment.

The ideal situation is that such exercising of control self assessment should be sufficient to give senior management and the Board of Directors sufficient information concerning the operations and the internal control, that they themselves are able to assess the need for improvement and to be aware of their position in relation to compliance with laws and regulations, as well as in meeting the expectation of the stakeholders.

0.5 Internal Audit

However, in complex and/or large organisations, experience shows that management sometimes lack the time, specialist skills, methodology and/or objectivity needed to effectively and fully monitor the operations of the organisation, including the systems of internal and business controls. In such instances, the furnishing of objective and timely appraisals of the quality of the organisation's internal control and systems for managing business risk, would contribute significantly to strengthening management's control of the operations, thus contributing to sound corporate governance.

The need for such appraisals is also apparent in enterprises which, by their nature, have a special standing. This would include public sector enterprises which, irrespective of size, perform especially vital public functions or which may reasonably be expected to be subject to close public scrutiny. Other examples would include financial institutions which are dependent on the confidence of investors and others who may entrust them with savings, long term financial planning etc.

Such appraisals can best be supplied by a function which is independent of line management and which has the professional expertise and methodology necessary to fill this important role. The establishment of such a professional appraisal function, called internal audit, must of course

be supplemental to management's own control self assessment mentioned above and may not reduce its responsibility for it.

Although internal audit in an enterprise would have no formal external reporting duties to stakeholders outside the enterprise, the presence of such a function would nonetheless give them considerable additional reassurance. The introduction of such a function would increase management awareness of its responsibility as regards sound corporate governance and ensure that management be provided with the evaluations and recommendations necessary to be able to secure and improve the operations of the enterprise.

The legal regulation of such a function would also ensure that directors and management, not only establish such functions, but also give sufficient consideration to the conclusions and recommendations provided by internal audit. This need was illustrated in the cases of BCCI and Barings Bank where in both cases internal audit gave clear warnings in writing to directors and senior management, but where necessary actions in response to their warnings were not taken.

These well known examples illustrate the potential value of internal auditing but at the same time expose the shortcomings of self-regulation. Experience shows that reliance on voluntary codes of conduct and internal procedures is often inadequate when an enterprise faces problems. As such, appropriate legislation should be introduced which would require evidence of an appropriate formalized consideration and follow-up of internal audit findings and recommendations.

It is ironic that illustrative examples of the value of successful internal auditing, receive minimal recognition outside of the enterprises concerned. This is often due to the fact that high quality internal auditing contributes to sound management and successful operations and the avoidance of crises, scandals etc. As such, the contribution of internal audit to the success of the enterprise remains anonymous.

As mentioned above, internal audit needs to be independent of the operations of the enterprise, in order to be able to make impartial assessments of how the operations are controlled by management. Such assessments also require unrestricted access to necessary information, documentation and personnel. Finally, the examples above have demonstrated the need for reports to be sent to the highest levels of management in keeping with the legal responsibility for corporate governance.

As such, internal audit should report to the highest level of executive management, or alternatively to a non-executive body established by the Board of Directors. Such bodies, often

called Audit Committees, are well known in the USA and in the UK and are gradually becoming more common in multi-national European corporations. A committee on corporate governance established by the employers' association in France has recently recommended such a development.

Internal auditing is primarily a service for top management and as such warrants an in-depth understanding of the aims, strategies and operations of the enterprise. In the opinion of the Confederation, this knowledge and understanding can best be achieved by entrusting internal auditing functions to personnel employed within the enterprise. This is further supported by the need for internal audit to be able to respond quickly to the changing business and control environments in the enterprise.

In some internal audit functions, there may be a need for specialist skills on a temporary or longer term basis. These needs are sometimes difficult to satisfy by permanent employment in an internal auditing department. This may especially apply to smaller internal audit functions. In such cases the enterprise may wish to employ external consultants to provide such additional services.

The question arises as to whether the enterprise's statutory auditors could fill such a role as an additional service. However, such a solution could seriously impair the independence of statutory auditors in relation to senior management. By providing a service of such vital significance to the exercising of corporate governance by executive management, including the Board, statutory auditors would be unable to objectively assess the results of such governance on behalf of owners, authorities etc. As such, a conflict of interest may arise, if the statutory auditor is to serve both owners and executive management.

With the exception of the fields of banking and insurance, most European countries have at present few, if any, regulations specifically requiring internal audit. However, company legislation and various directives and guidelines from regulatory authorities, often directly or indirectly encourage the establishment of internal auditing.

Recent financial crises and scandals show that the benefit and influence of internal auditing is greatest in enterprises where their conclusions and recommendations are given serious consideration by the Board and senior management. Experience shows, however, that the need for internal audit is indeed greatest in organisations which do not give sufficient priority to such matters. As such, the Confederation acknowledges that there is a need for legislation (ref. 2.6), both as regards the establishment of internal auditing in certain entities, and as regards the purpose, practice and consequences of this function.

0.6 Key conclusions

- If European enterprises are to avoid unnecessary collapses, crises, irregularities etc, it is essential that measures be implemented to ensure the establishment, performance and monitoring of **all** aspects of internal control (ref. 1.2). This is primarily the responsibility of directors and senior management.
- Reassurance regarding the quality of corporate governance should be strengthened, to meet the needs of stakeholders. However, formalized external reporting in the annual report should be restricted to an assessment of the financial and accounting controls.

- The duties of the statutory auditor should primarily be to issue an opinion on the financial statements of the enterprise and on the report from the Board and senior management as regards the quality of the financial and accounting controls.

- In addition to having systems within line management to monitor the quality of the internal control, directors and senior management need to be furnished with independent, objective appraisals of adequacy and quality of the controls established and confirmation that such controls are being satisfactorily executed on a continuous basis.

- Qualitative appraisals, including recommendations for action to improve internal control weaknesses, rectify errors and enhance sound management, can best be provided by a professional internal auditing function.

- The internal auditing function should report directly to the Chief Executive Officer, Board of Directors or an Audit Committee, in order to ensure necessary status, independence of line management, objectivity and response to recommendations.

- Internal auditing should preferably be carried out by a department within the enterprise. If special circumstances warrant the use of hired personnel, such services may not be managed by the statutory auditor of the enterprise.

- It is necessary for the European Union to introduce binding legislation for significant enterprises and sectors (ref Chapter 5), requiring the establishment of a professional internal auditing function and regulating qualifications/experience required and the duties of the Board and Chief Executive Officer in relation to internal audit conclusions and recommendations. Legislation would have some important advantages :

- it contributes to giving stakeholders equal reassurance, irrespective of member state, as regards the quality of corporate governance;
- it ensures necessary response and follow-up from senior management as regards the appraisals and recommendations furnished by internal audit, resulting in improved corporate governance;
- it ensures that individual countries do not regulate internal audit in different ways.

1. INTRODUCTION

1.1 Corporate governance

In recent years, corporate governance has been the subject of critically important discussions in many European countries as well as in the USA and Canada. In this context, the term corporate governance encompasses the proper management of corporations and public sector enterprises. Important elements are ethics, accountability to owners, creditors, authorities and the public-at-large, as well as demands for sound financial and operational control over the activities of the enterprise. Although not always focused individually, management's responsibility as regards employees is also of significance.

This debate has arisen due to a series of well-publicised crises, corporate collapses, fraudulent activities and other mismanagement and criminal activities, both in the private and public sector.

Internal auditors, and their professional organisations, have been active participants and commentators in these discussions. Although the statutory audit, with the resulting audit opinion, is deemed to be an important measure in monitoring the standard of certain limited aspects of corporate governance, **there is no doubt that many other forms of supervision, reporting and control evaluation are required in addition.**

One of the major challenges the debate on corporate governance sought to address, was the expectation gap between interested external parties and the key players in the management and control of private and public enterprises. As such, there is a clear expectation gap between external stakeholders (shareholders, authorities and the public-at-large) and top management as regards management's responsibility for establishing, maintaining and monitoring an effective system of internal control. One element of these responsibilities is the need for the issuance of timely, accurate and meaningful financial information.

Further, there exists an equally important expectation gap between the same external parties and the statutory auditors of such enterprises, as regards the purpose, scope and value of the work carried out by the auditors and the significance of reports/opinions issued by them.

1.2 Internal control

A major component in ensuring good corporate governance is the enterprise's system of internal control. Internal control has been defined in many international studies and these definitions, although not identical, show great similarities.

One of the definitions (Cadbury-report, UK) is as follows:

> "Internal control is the whole system of controls, financial and otherwise, established in order to provide reasonable assurance of :
>
> a) effective and efficient operations;
> b) internal financial control; and
> c) compliance with laws and regulations."

Another definition (COSO-report, USA) is as follows:

> "Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> a) effectiveness and efficiency of operations
> b) reliability of financial reporting
> c) compliance with applicable laws and regulations".

However, the most international definition is to be found in the Standards and guidelines of the Institute of Internal Auditors (IIA), which is as follows:

> "Internal controls are all activities which attempt to ensure the accomplishment of the organisation's objectives and goals.
>
> The primary objectives of internal control are to ensure:
> 1. the reliability and integrity of information
> 2. compliance with policies, plans, procedures, laws and regulations
> 3. the safeguarding of assets
> 4. the economical and efficient use of resources

5. the accomplishment of established objectives and goals for operations or programmes".

Similar definitions are to be found in all European countries, although there may be some less important differences in content or emphasis.

It is clear from all of the above definitions that sound financial management, including the issuance of accurate and reliable financial reports, only represents **one** element of the internal control necessary to ensure sound corporate governance.

Other aspects of internal control, including the achievement of operational objectives within a clearly defined legal and ethical framework, are equally essential.

If European enterprises are to avoid unnecessary collapses, crises, irregularities etc, it is essential that measures be implemented to ensure the establishment, performance and monitoring of <u>all</u> aspects of internal control.

As indicated at the start of this introduction, the statutory (external) audit is an important measure with regard to the monitoring of external financial reporting and certain elements of financial control. This position paper will demonstrate a similar need for **internal** auditing in order to ensure that the **whole** system of internal control be subject to such monitoring.

2. *THE NEEDS OF STAKEHOLDERS IN RELATION TO CORPORATE GOVERNANCE*

2.1 Key conclusions - international research

As mentioned above, corporate governance has been the subject of serious debate in all European countries. Several member states of the European Union and European Economic Area have established government commissions, working parties etc. for the purpose of issuing laws, regulations and guidelines on these matters.

However, the two reports which so far have been given most attention internationally are the so-called COSO-report from USA and the Cadbury-report from the United Kingdom. As regards the statutory audit, the major conclusions in these reports are almost identical. The Confederation has observed that the development in member countries on these same aspects of corporate governance, are in line with these findings.

The major findings of the above-mentioned reports are as follows:

1) The Board of Directors, or its equivalent in the public sector, and top management, have a responsibility to establish, maintain and monitor the internal control of the enterprise. (In a number of countries this responsibility for management is regulated by law, e.g. in a Companies Act or equivalent.)

   The reports adopt a **broad** definition of internal control. This definition encompasses all major activities of the enterprise and **is not restricted solely to the enterprise's accounting and financial control**. Indeed, when there are material weaknesses in vital operational information, systems and control, the continued existence of the enterprise may even be threatened.

2) The Board of Directors, or its equivalent in the public sector, should periodically (at least annually) issue external reports, for example in the Annual Report, regarding the quality and effectiveness of the internal financial and accounting control in the enterprise. The primary reason for this restriction in scope is the necessary degree of subjectivity involved, when reporting on other aspects of internal control.

The need for the above restriction was described in the COSO-report as follows:

"Focusing reports on controls over financial reporting puts an appropriate fence around internal control reporting, recognizing limitations and the state of the art. If the scope of reporting is extended to operations and compliance objectives, not only would efforts and related costs increase very substantially, but other problems would be encountered. This is because evaluating and reporting on controls over financial reporting are more well-developed disciplines".

(COSO, Reporting to External Parties, September 1992)

In following up the recommendation in the Cadbury-report, a working group comprising the accountancy profession and representatives of preparers of accounts issued a guidance regarding Internal Control and Financial Reporting for listed (Stock Exchange) Companies. In this guideline, directors and management are advised to specifically address "internal financial controls" which were defined as:

"The internal controls established in order to provide reasonable assurance of the maintenance of :

a) The safeguarding of assets against unauthorized use or disposition; and
b) the maintenance of proper accounting records and the reliability of financial information used within the business or for publication".

(Cadbury Committee, December 1994)

3) The statutory auditors of the enterprise should issue an opinion for the benefit of owners and other external interested parties as regards the quality and effectiveness of the internal **financial and accounting control** in the enterprise. This reporting from the statutory auditors is deemed relevant in that it directly affects the accuracy and completeness of the profit and loss account and balance sheet. The opinion does **not** evaluate **operational** aspects of internal control.

This external reporting in the form of an audit opinion, does not in any way reduce management's responsibility for the afore-mentioned internal control, but should be viewed as an independent objective assessment of this aspect of internal control.

4) The external reporting and issuance of opinions, as described in points 2 and 3 above, should be restricted to a "point-in-time" reporting.

The reasoning behind this recommendation was described in the COSO-report as follows:

"Reporting either for a period of time or at a point in time, such as an entity's year end, should meet the needs of security holders and other report users. Point-in-time reporting is, however, likely to be considered the preferred alternative. Point-in-time reporting provides a constructive focus, where management can focus primary attention on fixing problems on a timely basis, rather than on disclosing deficiencies that were identified during the year and promptly corrected".

The COSO-report further commented:

"..... a report covering an entire year will require an assessment on the effectiveness of the control system for the entire timeframe, a much more extensive process".

(COSO, Reporting to External Parties, September 1992)

2.2 A historical perspective

The need for an independent audit of financial statements arose when the ownership and management of a company became separated. The owners, as well as management, had a need for truth and fairness in financial reporting and confirmation was provided by the external auditors and to a certain extent also by internal auditors.

As private and public sector enterprises increased in size and complexity, various stakeholders acquired new and different needs. The need to adequately monitor the activities and performance of the enterprise became greater, whilst the above developments made such monitoring more difficult. The speed of this development, including changes in management techniques, market factors, technology etc., further emphasized the need to create new organisational and operational methods for ensuring adequate control of the enterprise and of its management.

Due to an increasing occurrence of failures, fraud and companies experiencing financial problems, the above-mentioned needs of stakeholders have recently become more clearly focused. It is clear that these needs are not of a purely financial nature. This has led to the international discussions mentioned above.

Many stakeholders have been identified, who have a direct interest in the financial and operating performance of the entity in question, without themselves having executive authority. This includes owners, employees, investors, banks, suppliers, customers and other persons or parties with similar direct relationships with the enterprise.

Additionally, one can also identify stakeholders who only indirectly may be affected, usually in the longer term, by the governance of the entity. This would usually include the market place (in the wider sense), government and regulatory bodies and the population-at-large. The European Union and its member states must also be classified as stakeholders, having a vested interest in the exercising, within the Union, of responsible, sound and stable corporate governance.

2.3 Stakeholders' needs

The statutory audit, both traditionally and in the light of newer international developments, seeks primarily to satisfy the needs of the direct stakeholders and, subordinately, the needs of indirect stakeholders. However, we see that **these needs are only partly fulfilled**, due to the necessary legal and practical restrictions which must be imposed, both in relation to the external financial reporting to the above-mentioned stakeholders, and as regards the purpose and scope of the audit opinion (see 2.1 above). As such, there is an identified need, which the statutory audit does not resolve, i.e. the need for assurance of sound corporate governance in the complete sense of the term.

The Institute of Chartered Accountants of Scotland (ICAS) has published an interesting study (1993) regarding the changing needs of stakeholders, in a publication named "Auditing into the twenty-first Century".

ICAS observes "that the public expects statutory auditors to provide reassurances that:

1. the financial statements are right;
2. the company will not fail;
3. there has been no fraud;
4. the company has acted within the law;
5. the company has been competently managed; and
6. the company has adopted a responsible attitude to environmental and societal matters."

Here again, it is clear that relatively little comfort can be expected if the sole basis is the work carried out, and the opinion issued, by the statutory auditor.

The study from ICAS examined each of the above expectations, and their conclusions can be briefly summarized as follows:

Re 1: The statutory audit is primarily aimed at giving such reassurance. However, the term "right" has clear limitations, due to the subjectivity in some accounting matters and the limitations inherent in the statutory auditor's concept of materiality. Further, the study emphasizes that correct financial statements are **management's** responsibility.

Re 2: In the UK, (as in the majority of European countries), the statutory auditor's duty to assess a company's "going concern" is, at the most, restricted to a 12-month period. The statutory audit considers "going concern" evaluations based on reasonableness, but it is **not a primary objective** of the audit.

Re 3: In all European countries, statutory audit procedures are designed to discover fraud **only** to the extent that it has a material impact on the financial statements. However, recent surveys in many countries confirm that many stakeholders still expect such reassurance.

Re 4: As in the other points, the most important observation is that **management has a duty to have a system of internal control** which ensures compliance. Very few of the relevant legal implications will naturally fall into the scope of a statutory audit. The requirement in many European countries that statutory auditors report illegal acts when they by design or inadvertently discover them during the course of the audit, **can by no means be considered sufficient reassurance.**

Re 5: The study concludes, not surprisingly, that it is unreasonable to expect such reassurances from the statutory auditors. This is partly due to the degree to subjectivity required in evaluations of management, and partly due to the lack of appropriate skills. The study emphasizes the **responsibility of a company's board of directors to monitor the competence of its management.**

Re 6: Again the study concludes that the comfort required must primarily be the result of good systems of internal control subject to **monitoring** by management.

> Current training and qualifications of statutory auditors in Europe are **not** in accordance with the requirements for this kind of auditing.

Another example is in banking in France, where the chief internal auditor is required to prepare an annual report regarding the monitoring of the bank's system of internal control.

2.4 Consequences for management

The Board of Directors and management are primarily responsible for providing necessary assurance to stakeholders, since they are the primary executors of corporate governance. As such, when considering the needs of different parties, senior management, including the Board, should form an opinion on the overall system of internal control and quality of operations. Such controls are directed towards internal challenges and problems as well as to the needs of the stakeholders.

However, it is impossible to give the desired reassurances with 100% certainty. Meeting the needs of stakeholders in certain areas cannot be economically justified. If every fraud should be detected and if compliance with all laws should be verified by statutory auditors, the costs would be prohibitive. It is also impossible to achieve.

What the stakeholders can and should expect, is that management and the Board of Directors have implemented sufficient measures to ensure that fraud and non-compliance are reduced to a minimum, and that the chance of detecting such events is as high as possible.

The needs of stakeholders are one element in the changing role of management. As mentioned above, factors such as increased growth, complexity of operations and technological developments also create challenges which management must be equipped to tackle. Increased internationalisation is another important factor in this regard. In order to meet the above challenges and requirements for the benefit of the enterprise and defined stakeholders, directors and management must establish, maintain and monitor a sound system of internal control that covers all the operations of the enterprise.

2.5 The need for internal audit

As concluded above, the need for reassurance of sound corporate governance can neither be supplied by external reporting by the Board, nor by the opinion issued by the statutory auditor.

International studies and research confirm that unrealistic requirements as to objectivity, combined with the legal implications of inaccurate or misleading external reporting, must lead to the conclusion that other measures are required. As such, there are several identified needs which neither external reporting, nor the opinion issued by statutory auditors, can seek to supply.

The Confederation is of the opinion that the needs of the stakeholders and of senior management and the Board of Directors, must be viewed to be of equal importance, since they are interrelated. The exercising of sound corporate governance is the very foundation on which confidence can be built, as regards the public and private sector in the member states of the European Union.

The defined responsibility of senior management and the Board of Directors for all aspects of internal control (i.e. not restricted to financial and accounting control) is of central importance in this respect.

In complex and/or large organisations, experience shows that management often lack the capacity, skills, methodology and/or objectivity needed to effectively monitor the operations of the organisation, including the systems of internal and business controls. In the opinion of the Confederation, the furnishing of objective and timely appraisals of the quality of the organisation's internal control and systems for managing business risk, would contribute significantly to strengthening management's control of the operations, thus contributing to sound corporate governance.

Such appraisals can best be supplied by a function which is independent of line management and which has the professional expertise and methodology necessary to fill this important role. The establishment of such a professional appraisal function, called **internal audit**, must of course be supplemental to the necessary monitoring and reporting structures established **within** line-management.

2.6 The need for regulation

A great number of organisations within the European Union, both in the private and public sector, have established internal audit functions as a necessary support to sound and efficient management. The initiative to establish such a function is most likely to be taken in enterprises which already have an established code and practice of good internal control. With such organisations there is clearly no need to impose a solution by regulation.

It is unfortunately apparent that many other organisations have not identified such a need and it may be argued that it is often in such enterprises that the need is greatest.

The Confederation is therefore of the opinion that it is necessary for the European Union to introduce binding legislation for certain enterprises and sectors, requiring the establishment of an appraisal function within the organisation to assist executive management in fulfilling the responsibilities placed upon them.

The establishment of such a function, to be termed professional internal auditing, being independent of line management, satisfies the needs for executive management to monitor the quality of both the financial and operational internal control and the quality of the performance of sound corporate governance. In addition, internal auditing indirectly satisfies the needs of the stakeholders by increasing likelihood that such governance is being satisfactorily enacted and that operational and business risks are subject to management control.

In reaching the conclusion that it is imperative for some enterprises to have internal auditing through the introduction of relevant legislation, the Confederation has drawn on experiences from individual companies, sectors and countries.

An illustrative example is a series of legislative measures introduced in Norway following the collapse of several of the largest Norwegian banks. In 1994 The Banking, Insurance and Securities Commission introduced legislation formalizing internal control requirements **including** non-financial elements of internal control. The legislation further required an appraisal of this internal control including a separate evaluation of management's own monitoring of such control and of the operations of the bank. This appraisal must be carried out by a function independent of line management, i.e. internal audit or the equivalent.

The effect of the above legislation has been dramatic. Directors and senior management have actively initiated and participated in measures designed to improve business risk management and other important aspects of corporate governance. The resulting increased quality in management's own understanding of the importance of internal control has unquestionably justified the introduction of legislation.

Another example is Sweden where a regulation was passed in June 1995 requiring internal audit for all state-controlled enterprises. The regulation states that internal auditing shall encompass all the operations of the enterprise.

In line with experiences gained from other professions and matters relating to international operations in the private and public sector, European Union legislation on internal auditing would has many advantages:

- it contributes to giving stakeholders equal reassurance, irrespective of member state, as regards the quality of corporate governance

- it ensures necessary response and follow-up from senior management as regards the appraisals and recommendations furnished by internal audit, resulting in improved corporate governance

- it ensures that individual countries do not regulate internal audit in different ways

- it removes professional barriers which restrict the efficient interchange of internal auditing professionals between member states

- it promotes the efficient use of resources in European multinational companies due to the establishment of multinational group internal audit departments

- the internal auditing profession can further harmonize European internal auditing standards

- the internal auditing profession can develop European requirements as to qualifications/certification and working methods, including harmonization at European universities and colleges.

As described in chapters 3 and 4 of this position paper, the profession in Europe, assisted by the ECIIA, has in recent years appreciated the need for European harmonization. However it is apparent that the profession's own efforts as regards, inter alia, setting of standards, certification etc., should now be supplemented by necessary European legislation.

3. DEFINITION, PURPOSE AND SCOPE OF INTERNAL AUDITING

3.1 Definition and purpose of internal auditing

The accepted international definition of Internal Audit is:

"An independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed. The objective includes promoting effective control at reasonable cost."

(The Institute of Internal Auditors - Statement of Responsibilities, 1947)

The international studies mentioned above have also attempted to define internal auditing and the role of internal auditors. The following excerpts illustrate the nature of the demand which is addressed by the profession:

"Internal auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role."

(COSO, September 1992)

"In larger companies, an internal audit function, independent of line management, forms part of a continuing monitoring process and is also available for particular control initiatives outside the day-to-day business routines."

(Cadbury, October 1993)

"To provide a Board of Directors with reassurances that its management information systems and internal control systems are sufficiently reliable and relevant, we believe each company should establish and maintain a strong internal audit function under the direction of a Chief Internal Auditor."

(ICAS, May 1993)

3.2 The Scope of Internal Auditing

Definition:

General Standard 300 of the Institute of Internal Auditors defines "Scope of Work" as follows:

> *"The scope of internal auditing should encompass the examination and evaluation of the adequacy and effectiveness of the organisation's system of internal control and the quality of performance in carrying out assigned responsibilities"*

The scope of internal auditing is further described by examining the scope of the internal control subject to examination by the internal auditor. This is defined and structured in the professional standards as follows:

310 Reliability and Integrity of Information

Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.

320 Compliance with Policies, Plans, Procedures, Laws, and Regulations

Internal auditors should review the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations which could have a significant impact on operations and reports and should determine whether the organization is in compliance.

330 Safeguarding of Assets

Internal auditors should review the means of safeguarding assets and, as appropriate, verify the existence of such assets.

340 Economical and Efficient Use of Resources

Internal Auditors should appraise the economy and efficiency with which resources are employed.

350 Accomplishment of Established Objectives and Goals for Operations or Programs

Internal auditors should review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

(The Institute of Internal Auditors - Standards nos 310 - 350, 1978)

There are of course several ways of structuring these elements, but it is noticeable that the content and interpretations have now reached an international consensus, as is indicated by the description of scope used in the follow-up to the Cadbury Report in the United Kingdom.

Typical tasks for internal audit include:

- *reviews of the design and operation of the accounting system and related internal controls;*
- *examinations of the financial and operating information systems;*
- *reviews of the economy, efficiency and effectiveness of operations and of the functioning of non-financial control;*
- *reviews of the implementation of corporate policies, plans and procedures;*
- *special investigations.*

(Cadbury, October 1993)

As can be seen, both from the professional standards for the profession, and from other sources, the scope of internal auditing is comprehensive. This is one of the major differences between internal and external auditing. Often-used terminology is that external auditors carry out **financial** auditing, whereas internal auditing usually encompasses **financial, operational and compliance** auditing. This scope is also reflected in the examinations and certification of internal auditors, where all the above forms of auditing are tested. The professional standards (100 - 500) and the so-called Statements of Internal Auditing Standards (SIAS 1-13) reflect this important difference (appendix 2). An illustration of this fact is that both fraud and the

achievement of management's operational objectives are the subject of separate standards, i.e. SIAS nos. 3 and 10.

3.3 Qualifications

Internal auditing work should be performed with proficiency and due professional care. It is the view of the Confederation that this requires that the internal auditing function should collectively possess the knowledge and skills essential to the practice of the profession within the organisation. These attributes include proficiency in applying internal auditing standards, procedures and techniques, as well as knowledge of management principles and methods.

Internal auditing institutes have recognised the importance of this matter and provide their members with an ongoing and continuous training and development program, covering all aspects of the profession. The education programs have culminated in an international professional qualification called "Certified Internal Auditor (CIA)" in addition to several national qualifications. The examinations leading to certification reflect the previously mentioned scope of internal auditing and the knowledge and skills required. This is illustrated by the syllabus for the CIA-examinations (see appendix 5).

It is important to understand the significance of the scope of internal auditing as regards qualifications and backgrounds in the profession. Internal auditors may be lawyers, engineers, economists, accountants and/or experts in fields such as information technology, marketing, environmental matters and logistics.

There is a clear trend towards such multi-disciplinary internal audit functions. The combination of such skills together with internal auditing expertise and methodology provides a powerful background for evaluating the quality of corporate governance in an enterprise.

The Confederation believes that the same guidelines should be applied to internal auditing as to statutory external auditing. To ensure quality in the work performed it should therefore be emphasised in EU regulations that the internal auditing function within the defined companies, public entities and sectors should be led by a person with recognized qualifications and experience in internal auditing. A natural further development would be a program of harmonization in the European profession leading to reciprocity as regards qualifications in different countries.

3.4 The Benefits of Internal Auditing

To a great extent, the benefits and need for internal auditing are apparent when examining the profession's purpose and scope of work. However, certain additional benefits are as follows:

- **internal audit provides continuity in the monitoring process**. One of the most severe limitations of the statutory audit is that the reassurance given to stakeholders is necessarily based on historical data and is given "after the event", i.e. sometime following the financial year. Internal auditing's evaluations, recommendations and reports, being on a continuous basis throughout the year, provide stakeholders with valuable additional comfort.

  A further advantage of this continuity is that management is able to implement corrective measures and improvements on a timely basis.

- **internal audit has a considerable knowledge of the enterprise.** Due to the wide scope of internal auditing and the continuity mentioned above, internal auditing gains considerable insight and knowledge of the organisation and operations of the enterprise. This enables internal auditors to combine their professional training and skills with an understanding of the enterprise's operations, in order to make judgements about the effectiveness and efficiency of such operations and management's achievement of short and long term objectives and goals.

- **internal audit contributes to the enterprise's quality assurance.** The statutory auditor usually restricts the compliance aspects of its auditing to primarily cover external regulations. This is both for reasons of costs and the need for restricted legal liability. The quality of operations, including compliance with policies, procedures and internal regulations is, however, of fundamental importance if the enterprise is to achieve its defined objectives in a secure, economic and efficient manner. This point can be illustrated by the fact that a **corporation may become bankrupt even though it has followed all legal requirements and presented accurate financial statements**. As such internal auditors have an important role in periodically monitoring compliance with internally defined control procedures, regulations etc.

In relation to the above, it is interesting to note that considerable resources are currently being built up within many European enterprises to improve the establishment and monitoring of quality systems, including the increased popularity of ISO 9000-certification etc. More recently, a similar development has been noticed in the environmental field. Quality auditing and environmental auditing are increasingly becoming a natural part of the internal audit function and scope of work. This provides a valuable increase in efficiency and concentration of skills within the organisation.

- **internal audit is a service to the organisation.** Statutory auditors are primarily responsible to owners and regulatory authorities. They also have the aforementioned restrictions on scope as well as limitations caused by after-the-event reporting. Internal auditors, not having these restrictions, are in a unique position to be able to furnish the Board of Directors and senior management with necessary analyses, appraisals and recommendations (see 3.1 above). As such internal auditing provides a service of great value as regards corporate governance.

  In several countries there is increasing concern about the possible threat to independence and objectivity when statutory auditors perform consultancy work for directors and management. Indeed, some countries, including France have placed restrictions on such work. Internal audit does not have such a conflict of interest in that they do not have formal responsibilities in relation to external parties (see 4.1).

3.5 The International Profession

Internal auditing first emerged as a professional discipline over 50 years ago, although the concept and practice of it has a history spanning centuries. The Profession was first formally organised in the USA in 1941, with the formation of the Institute of Internal Auditors Incorporated (IIA Inc.).

For the first few years, IIA Inc. concentrated on consolidating its home base, by setting up various Chapters and Clubs in North America. In 1948, the first European Chapter was set up in London, soon followed by another in the North of England. Since that time IIA Inc. has grown into an International organisation serving the interests of more than 52.000 members world-

wide, of whom 60 % reside in North America. Most of the European organisations are either National Institutes or Chapters belonging to the International organisation.

The continuing growth of membership outside North America has brought with it a requirement for IIA Inc. to more positively become an international organisation. Professional volunteer positions in the governing structures and important professional committees are increasingly being filled by non-Americans.

A high powered task force, led by a European, has been working for three years, developing a new "Globalisation" strategy, through which a new global umbrella organisation will evolve. Clearly, the European Confederation, currently representing approximately 11.000 members will have a key international role to play, as well as catering for the further development of a European Profession.

Early in the 1970s, IIA Inc. consolidated the thrusts of education contained in numerous training courses, seminars etc., into an examined programme of professional education, culminating in the award of a professional qualification called "Certified Internal Auditor (CIA)". This is now being successfully promoted as an international qualification. One of the key projects under development in the European Confederation is the creation of a European Certification programme. This is likely to contain four sections, three of which will be based on sets of international papers and one which may be either National-European or Pan-European in nature. Many of the member organisations of ECIIA have already embarked on national programmes, some of which are aligned to the CIA. Others, have developed alternative routes, notably the UK, which has its own professional qualification, MIIA.

The International Institute first published a set of "Standards and Guidelines for the Professional Practice of Internal Auditing" in 1978. This was preceded by a "Code of Ethics" and a "Statement of Responsibilities of Internal Auditing (first issued in 1947)". The profession thereby conforms to strictly defined and imposed regulatory disciplines which accord with the accepted marks of a professional body. These documents are fully accepted by all member bodies of IIA Inc.

There have of necessity been translations into languages other than the original English, including a rewrite by UK into the European form of English (as opposed to American).

3.6 The European Profession

The European Confederation of Institutes of Internal Auditing (ECIIA) was founded in 1982 by a number of European National Institutes, which then collectively represented fewer than 3000

members. It has since grown to include 19 European Nations plus Israel and is the European voice for around 11.000 internal auditors.

The Confederation is governed by a General Assembly, in which each member organisation has one vote. The day-to-day business of the Confederation is run by an executive committee consisting of the ECIIA President, three Vice-Presidents (each of whom chairs a professional council), a Treasurer and a Secretary.

The work of the Professional Councils is based on the Confederation's mission statement:

> "to promote and develop the professional practice of Internal Auditing in Europe to the benefits of the Profession in all member countries through its Member Organisations"

Each Professional Council has several working committees, staffed by volunteers from different countries. The Three Councils are:

> **Professional Practices Council,** which leads the development of training, certification, standards and professional issues.
>
> **Professional Development Council,** which organises conferences, seminars, forums, enabling internal auditors to meet and debate matters of professional interest.
>
> **Professional Services Council,** which looks for ways of storing and communicating information, including publishing a Newsletter.

The Executive Committee also appoints a European Research Coordinator, who works in liaison with the research officers of member organisations and IIA Inc.

4. ORGANISING AN INTERNAL AUDIT FUNCTION

The internal auditing profession has, for many years, recognized that characteristics and criteria need to be established by which the operations of an internal auditing department are evaluated and measured. Also, it is realized that continuous changes in organizations and in society require the profession to adapt and change in order to keep abreast of developments, so that the organisations for whom internal auditors work will be adequately served.

The following are core characteristics which the Confederation believes need to be in place within the profession in the European Union.

4.1 Independence

One important requisite of statutory auditors is that they are **independent of the management of the enterprise** they audit. As regards internal auditing this requirement clearly needs to be modified in order to reap the benefits of the contribution they can make to improve corporate governance. As such, internal auditors should be **independent of the activities/operations** they audit.

"Internal auditors are independent when they can carry out their work freely and objectively. Independence permits internal auditors to render the unpartial and unbiased judgements essential to the proper conduct of audits. It is achieved through organisational status and objectivity".

(The Institute of Internal Auditors - Guideline 100.01)

Independence through organisational status is achieved when the status of the internal auditing department is sufficient to permit the accomplishment of its responsibilities. This includes support from senior management and the Board so that internal auditors can gain the cooperation of auditees and perform their work free from interference. It implies that the director of internal auditing should be responsible to an individual, or body, within the organization with sufficient authority to promote independence. This will usually be the Chief Executive Officer. It also implies that the director of internal auditing should have direct and regular communication with the Board. In some organisations, internal audit reports directly to the Board or a sub-committee established by the Board (see 4.2).

The purpose, authority and responsibility of the internal auditing function should be defined in a formal written document (charter) which should be approved by senior management and/or approved or ratified by the Board.
Objectivity is an independent mental attitude which internal auditors must maintain in performing audits. The profession has recognised the importance of this principle which has been formalised in the "Code of Ethics" of the Institute of Internal Auditors.

Objectivity implies, inter alia, that internal auditors should not assume operating responsibilities. The Confederation strongly believes that performance of internal auditing work along with other roles or responsibilities adversely affects objectivity and therefore reduces the effectiveness of the function.

4.2 Audit Committees

The Confederation believes that organisations should have a mechanism to ensure that the Board recognises its responsibilities as regards corporate governance, including financial reporting and internal control.

An audit committee is such a mechanism, which is well established in some countries, e.g. in USA and UK, primarily in the private sector. An audit committee gives greater focus to the work carried out in the enterprise, related to important control activities, management's monitoring of operations and the timeliness and effectiveness in preventing, detecting and follow-up of problems.

The committee, which should be a standing committee of the main Board, should preferably be comprised exclusively of non-executive directors, independent of the business. It is responsible to the Board as regards

(a) the internal accounting and financial control,

(b) the financial reporting process,

(c) the statutory (external) audit thereof,

(d) the internal control other than that which is directly related to accurate financial reporting,

(e) the review of (a), (b) and (d) by internal audit.

As regards (a) and (b) the audit committee will look to both the internal and external auditors for analyses, views and information. As regards (d) this role will, under normal circumstances, be filled by internal audit.

4.3 Internal Auditing and External Reporting on Internal Control

As mentioned in the introduction to this paper, the Board of directors (or its equivalent in the public sector) should periodically issue external reports regarding the quality and effectiveness of the internal financial and accounting control in the enterprise.

The Confederation believes that such reports should, inter alia, be based on formal reviews of the system of internal financial and accounting control, performed by the internal auditing department. Indeed, the paper from ICAS proposes that this method of working should specifically be mentioned in the external report from the Board of Directors. As such ICAS's proposed format includes the following:

"Based on our own knowledge and on the reassurances given to us by our Chief Internal Auditor we believe that we have fulfilled these responsibilities in all material respects."

Internal auditors should, as part of their work, report regularly to management on this aspect of internal control, which will provide management with an adequate framework and information to provide the necessary external reporting.

The internal auditing function, because of its independence, objectivity and qualifications is uniquely positioned to assist management in achieving this important objective.

4.4 Relationship of Internal Auditing with Statutory Audit

The scope of internal auditing work usually encompasses both financial and operational objectives and activities, with the emphasis usually on operational auditing in modern departments. However, the statutory auditors' examination is designed to obtain sufficient evidential matter to support an opinion on the overall truth and fairness of the annual financial statements. This examination is governed by statutory audit standards.

It is the view of the Confederation that, while scope and objectives of internal and statutory auditing differ, coordination of the work may, in certain circumstances, be beneficial and should be done to the extent that professional and organizational responsibilities allow. It is therefore the privilege and duty of senior management and/or the Board to decide to what extent they wish internal audit to perform work of specific benefit to the external auditor.

It is important to emphasize that the benefit of coordinating internal and external audit work is primarily in relation to the purpose and scope of the statutory audit work. As such the main benefit is to be found in the area of financial and accounting control, as well as work carried out on veryfying accounting information and reports. As regards the operational auditing carried out by internal audit, there is considerably less need for a professional cooperation.

There can be no doubt that the need to avoid a conflict between the interests of senior management of the enterprise and those of external stakeholders, requires a certain caution as regards the closeness of the above cooperation. Statutory auditors primarily represent external stakeholders whereas internal auditors primarily represent the Board of Directors and/or the Chief Executive Officer.

Any such coordination should be the responsibility of the director of internal auditing. This is also reflected in the international standards.

"The director of internal auditing should coordinate internal and external audit efforts"

(The Institute of Internal Auditors - Standard 550, 1978).

The Confederation believes that active support by the Board or Audit Committee is required to achieve effective coordination of work.

However, it is essential that all parties are aware of the different roles played by internal and statutory (external) auditors. A vital factor in this respect, as mentioned above, is that these auditors have **completely different** "employers". In the same way that external auditors must exercise care when asked to perform consultancy work for management (to avoid problems of

independence) it is equally important that internal auditors do not seem to be serving the interests of external auditors instead of serving their own management.

In the public sector the scope and nature of the audit are more often similar for internal and governmental/local authority auditors. This is due to the fact that they often carry out both financial, compliance and performance/operational auditing. In this sector the differences as regards "employer" are, however, at least as important as in the private sector.

4.5 Relationship of Internal Auditing with Management

Although the need for independence and objectivity has been emphasized in this position paper, there is no doubt that internal auditing is a tool for the most senior executive level in an organisation. As described above, internal auditing therefore directly serves the needs of these customers.

In larger organisations, internal auditing is usually performed by personnel formally employed in the enterprise. The Confederation recognises that such services could also be provided by external consultants, provided all conditions as regards duties, qualifications and proficiency are met. However, we are of the opinion that the establishment of an internal department is unquestionably the best solution in larger enterprises where it is possible to establish and develop a professional and competent unit. The use of external resources, often termed "outsourcing", also limits the advantages to be gained from having a thorough and continuous knowledge of the enterprise.

Even if special circumstances warrant some services be provided by external suppliers, it is essential that the enterprise retains management and control of the internal auditing function. As such, the management of the audit process, setting of audit scope and final decision making regarding implementation of recommendations, must remain within the organisation. Ideally this role should be assumed by a competent professional internal auditor. If the size of the enterprise makes such a solution impractical, then the management and control of the function should be assumed by a senior member of management, or a committee established for this purpose.

The question arises as to whether the enterprise's statutory auditors could fill the role of internal auditors, as an additional service. However, such a solution could seriously impair the independence of statutory auditors in relation to senior management. By providing a service of such vital significance to the exercising of corporate governance by executive management, including the Board, statutory auditors would be unable to objectively assess the results of such governance on behalf of owners, authorities etc.

The Confederation is therefore of the opinion that internal auditing should preferably be supplied by an internal department or in special circumstances by a qualified external supplier of such services,

but **with the restriction that such a supplier may not include the statutory auditor** for the enterprise.

This conclusion is supported by similar opinions expressed in several countries, including representatives of several regulatory authorities (like the SEC) and the international Institute of Internal Auditors. A similar stance is also included in the paper from The Institute of Chartered Accountants in Scotland (ICAS).

5. SECTORS/ENTERPRISES

On conceptual grounds we believe that internal audit needs to be established in all significant entities irrespective of the sector to which they belong. However, our argument for the importance and value of establishing such a function goes beyond theoretical debates and into arguing that senior management in these entities should be accountable -to the wider society - for the actions of themselves and their organisations on both moral and economic grounds. In order to achieve these objectives, entities need to establish a function which would provide directors and senior management with the assurance they require in this context.

The term "significant entities" may relate to size, financial influence or the significance of an enterprise in society.

In corporations with a large shareholder base and complex operations, the interests of owners, lenders, suppliers and employees are clearly important. Less obvious factors may be the effect of a corporate collapse on a local community/region or the effects of mismanagement or fraud on the trust placed in charitable organisations by society as a whole.

Finally, there are a large number of enterprises which are placed in a special position of trust as regards expenditure of taxpayers' funds and/or their role in the public sector infrastructure.

Looking carefully at the entities within the different sectors, it is the view of the Confederation that an internal audit function needs to be established - within the framework developed in compliance with the international IIA standards - along the following lines:

I Public sector

* All significant entities within the public sector, including companies, should have an internal audit function. These will include Supra National Bodies eg. The European Union Institutions; National Bodies e.g. Government Departments; Regional/State/Provincial authorities and Local authorities.

  The number of entities involved - based on the assumption that 500 of these organisations exist in larger EU countries (UK, France, Germany, Italy and Spain) and around 300 in smaller countries - is approximately 6,000 entities.

II ***Private sector***

* All entities within the Financial Services Sub-Sector - irrespective of size - should have an internal audit function. This is based on our belief that the accountability of executive management must be the subject of special attention in entities entrusted with savings, pensions and investments. This is supported by unfortunate experiences in recent years in this sector and is also in accordance with existing requirements in EU banking and insurance directives.

  It is worth noting that some of these will be listed companies whilst others may be privately owned or mutual funds owned by their members.

* Other entities should have an internal audit function if they satisfy <u>at least one</u> of the following conditions:

  a) Listed on a recognised Stock Exchange - there are an estimated 7,500 companies in this category.

  b) Limited liability companies, as defined in the 4th EU directive, i.e. an entity satisfying two of the following criteria:

     * Turnover greater than ECU 20 million
     * Balance sheet (total assets) to exceed ECU 10 million
     * Average number of employees exceeds 250

III ***Other sectors: (eg. Charities)***

* Large (as defined in ***II*** b above) charities should be required to have an internal audit department. It is difficult to estimate the number of these, but in the region of 2,000 organisations are likely to be involved.

  It may be argued that not-for-profit organisations, including trade unions etc, which are primarily funded by charitable donations and contributions from public funds, should be placed in the same category as the financial service sector. This is due to the special trust placed in the hands of the executives of such organisations. The Confederation is at

present uncertain as to how such organisations should be categorized in respect of internal audit requirements.

APPENDICES 1 - 5

Appendix 1 to Paper

DEFINITION OF TERMS USED IN THIS DOCUMENT

There are a number of terms used in internal auditing, and therefore in this document, which have been given specific meanings. These are as follows:

1. The term **board** includes boards of directors, audit committee of such boards, heads of agencies or legislative bodies to whom internal auditors report, boards of governors or trustees of nonprofit organizations, and any other designated governing bodies of organizations.

2. The term **chief internal auditor** identifies the top position in an internal auditing department .

3. The term **internal auditing department** includes any unit or activity within an organisation which performs internal auditing functions.

4. The term **auditee** includes any unit or activity within an organization that is audited.

5. The term **management** includes anyone in an organization with responsibilities for setting and/or achieving objectives.

6. The term **external auditors** refers to those audit professionals who perform independent annual audits of an organization's financial statements.

7. **Objectives** are the broadest statements of what the organization chooses to accomplish.

8. **Goals** are specific objectives of specific systems and may be otherwise referred to as operating or program objectives or goals, operating standards, performance levels, targets or expected results.

9. A **system (process, operation, function or activity)** is an arrangement, a set, or a collection of concepts, parts, activities and/or people that are connected or interrelated to

achieve objectives and goals. (This definition applies to both manual and automated systems.) A system may also be a collection of subsystems operating together for a common objective or goal.

10. **Internal control** is a process within an organization designed to provide reasonable assurance regarding the achievement of the following primary objectives:
    - The reliability and integrity of information
    - Compliance with policies, plans, procedures, laws and regulations
    - The safeguarding of assets
    - The economical and efficient use of resources
    - The accomplishment of established objectives and goals for operations and programs.

11. The term **financial services** indicates a specific employment area for internal auditors. The financial services industry is comprised of: banking; insurance; money markets; stock exchanges; building societies and other organisations which act as advisors or brokers to that industry.

12. The term **public sector** is a generic term encompassing central government departments, local government authorities (including regional and district organisations), parliaments and any industries or organisations controlled or funded by them, or wholly financed from public funds. The European Parliament and the European Commission are included.

13. The term **large private company** includes all companies listed on stock exchanges and all other companies in the private sector, who, as a consequence of their size, measured by turnover, capital or number of employees or any another similar indicator, are comparable in size to listed companies.

14. The term **large other** refers to any other organisation which does not fall within the definition for financial services, public sector or large private company, but which by reasonably measures criteria, is deemed to be large enough to require to the services of an internal audit department.

15. The term **corporate governance** was coined by the Cadbury Committee in its report on "**The Financial Aspects of Corporate Governance**" dated December 1, 1992. It

signifies the responsibility, in law, of all directors for the stewardship of the company's assets. "All directors, therefore, whether or not they have executive responsibilities, have a monitoring role and are responsible for ensuring that the necessary controls over the activities or their companies are in place - and working." (see item 10 above)

CURRENT INTERNAL AUDIT PRACTICE - WORLD-WIDE

Summary of General and Specific Standards for the Professional Practice of Internal Auditing, issued by the Institute of Internal Auditors in 1978.

100 Independence - Internal auditors should be independent of the activities they audit.

110 Organizational Status - The organizational status of the internal auditing department should be sufficient to permit the accomplishment of its audit responsibilities.

120 Objectivity - Internal auditors should be objective in performing audits.

200 Professional Proficiency - Internal audits should be performed with proficiency and due professional care.

The Internal Auditing Department

210 Staffing - The internal auditing department should provide assurance that the technical proficiency and educational background of internal auditors are appropriate for the audits to be performed.

220 Knowledge, Skills, and Disciplines - The internal auditing department should possess or should obtain the knowledge, skills and disciplines needed to carry out its audit responsibilities.

230 Supervision - The internal auditing department should provide assurance that internal audits are properly supervised.

The Internal Auditor

240 Compliance with Standards of Conduct - Internal auditors should comply with professional standards of conduct.

250 Knowledge, Skills, and Disciplines - Internal auditors should possess the knowledge, skills, and disciplines essential to the performance of internal audits.

260 Human Relations and Communications - Internal auditors should be skilled in dealing with people and in communicating effectively.

270 Continuing Education - Internal auditors should maintain their technical competence through continuing education.

280 Due Professional Care - Internal auditors should exercise due professional care in performing internal audits.

300 **Scope of Work** - The scope of internal auditing should encompass the examination and evaluation of the adequacy and effectiveness of the organisation's system of internal control and the quality of performance in carrying out assigned responsibilities.

310 Reliability and Integrity of Information - Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.

320 Compliance with Policies, Plans, Procedures, Laws and Regulations Internal auditors should review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant impact on operations and reports and should determine whether the organisation is in compliance.

330 Safeguarding of Assets - Internal auditors should review the means of safeguarding assets and, as appropriate, verify the existence of such assets.

340 Economical and Efficient use of Resources - Internal auditors should appraise the economy and efficiency with which resources are employed.

350 Accomplishment of Established Objectives and Goals for Operations or Programmes - Internal auditors should review operations or programmes to ascertain

whether results are consistent with established objectives and goals and whether the operations are being carried out as planned.

400 **Performance of Audit Work** - Audit work should include planning the audit, examining and evaluating information, communicating results, and following up.

410 Planning the Audit - Internal auditors should plan each audit.

420 Examining and Evaluating Information - Internal auditors should collect, analyze, interpret, and document information to support audit results.

430 Communicating Results - Internal auditors should report the results of their audit work.

440 Following Up - Internal auditors should follow up to ascertain that appropriate action is taken on reported audit findings.

500 **Management of the Internal Auditing Department** - The director of internal auditing should properly manage the internal auditing department.

510 Purpose, Authority, and Responsibility - The director of internal auditing should have a statement of purpose, authority, and responsibility for the internal auditing department.

520 Planning - The director of internal auditing should establish plans to carry out the responsibilities of the internal auditing department.

530 Policies and Procedures - The director of internal auditing should provide written policies and procedures to guide the audit staff.

540 Personnel Management and Development - The director of internal auditing should establish a program for selecting and developing the human resources of the internal auditing department.

550 External Auditors - The director of internal auditing should coordinate internal and external audit efforts.

560 Quality Assurance - The director of internal auditing should establish and maintain a quality assurance program to evaluate the operations of the internal auditing department.

STATEMENTS ON INTERNAL AUDITING STANDARDS (SIAS)

SIAS No. 1	Control: Concepts and Responsibilities (July 1983)
SIAS No. 2	Communicating Results (July 1983)
SIAS No. 3	Deterrence, Detection, Investigation, and Reporting of Fraud (May 1985)
SIAS No. 4	Quality Assurance (November 1986)
SIAS No. 5	Internal Auditors' Relationships with Independent Outside Auditors (June 1987)
SIAS No. 6	Audit Working Papers (December 1987)
SIAS No. 7	Communication with the Board of Directors (June 1989)
SIAS No. 8	Analytical Auditing Procedures (December 1991)
SIAS No. 9	Risk Assessment (December 1991)
SIAS No. 10	Evaluating the Accomplishment of Established Objectives and Goals for Operations or Programs (December 1991)
SIAS No. 11	1992 Omnibus Statement (December 1992)
SIAS No. 12	Planning the Audit Assignment (December 1992)
SIAS No. 13	Follow-Up on Reported Audit Findings (March 1993)
SIAS No. 14	Glossary (December 1995)

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ECIIA Regulations	Published by ECIIA May 1991
ECIIA Policies and Procedures	Published by ECIIA November 1992
Research - Survey of ECIIA Members "Internal Audit in the Year 2000"	Published by IIA Spain April 1992
Research - Survey of ECIIA Members "Regulation and Statutory Control of Internal Audit Functions"	ECIIA May 1994
Report on the Financial Aspects of Corporate Governance	Cadbury Committee - UK December 1992
Discussion Document - Research Committee "Auditing into the Twenty-first Century	Published by The Institute of Chartered Accountants of Scotland May 1993
Internal Control - Integrated Framework ("COSO-report")	Committee of Sponsoring Organisations of the Treadway Commission September 1992

CERTIFIED INTERNAL AUDIT (CIA) EXAMINATION

Summary of content

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